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Policy Notes

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Has Foreign Entry Made Domestic Banks More Efficient?

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In the 1990s, the Philippine government set about on two courses of action that were intended to increase the efficiency of domestic banks. One was the passage in 1994 of Republic Act No. 7721 or "An Act Liberalizing the Entry and Scope of Operations of Foreign Banks in the Philippines" which aimed at allowing greater participation of foreign banks in the domestic market. The other was the enactment, in increments, of various regulations throughout the 1990s which aimed at providing incentives to attract foreign ownership of common stocks in Philippine companies, including in domestic banks. Both moves were premised on the theory that greater foreign presence—and thereby competition—would encourage sounder banking practices among local banks.

Has foreign entry indeed made domestic banks more efficient?

This *Notes*—based on the findings of an earlier study conducted by these authors—examines this matter and presents some suggestions that may further improve the operations of domestic banks.

Background/Framework

The research literature suggests that increases in foreign bank entry and greater foreign ownership of domestic banks provide benefits to a domestic banking market. Three of the more important purported benefits are: (a) domestic banks will be compelled to operate more efficiently due to a narrowing of interest rate spreads and a decline in profitability as new foreign competitors reduce the market price of funds in an attempt to build market share, (b) banking practices will improve as foreign banks tend to be less politically connected and less likely to exert self-promotional influence on the regulatory authorities, and (c) many problems associated with the lack of effective monitoring and prevalence of rela-

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This *Notes* is based on PASCN Discussion Paper No. 2001-08 entitled "The Impact of the Liberalization of Foreign Bank Entry on the Philippine Domestic Banking Market" by the same authors under the auspices of the Philippine APEC Study Center Network (PASCN). The views expressed are those of the authors and do not necessarily reflect those of PIDS or PASCN or any of the study's sponsors.

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tional banking practices that are characteristic of emerging market economies may be alleviated.

In the Philippines, family corporate groups control a large portion of corporate assets and have significant ownership in large commercial banks. A decline in family group influence is argued to be associated with a decline in the presence of relationship-based banking and in turn may enable large commercial banks to better monitor corporate activities.

Within the above framework, we looked into the effects of foreign bank entry and changes in foreign ownership on the operation and structure of domestic banks in the Philippines, using bank-level accounting data from a sample of 16 expanded commercial banks (ECBs)[1] and general macroeconomic data for the period 1990-1998.

The changing banking landscape

The banking liberalization introduced with Republic Act No. 7721 has obviously changed the landscape of banking in the Philippines. For one, the number of foreign-owned commercial banks increased from 4 in 1994 to 14 in 1995. On a percentage basis, this represents an increase from 12.1 to 31.1 percent of the total number of commercial banks. Similarly, there has been a gradual rise in the amount of total assets and liabilities after 1995. From a decline in their average size experienced in 1995 (from P21.6 million in 1994 to P8.2 million in 1995), the foreign-owned commercial banks' average size zoomed and even surpassed its 1994 level at P29.8 million. This development indicates that foreign banks have indeed taken more significant positions in the Philippine banking sector. At the same time, the percentage of foreign ownership in domestic ECBs increased markedly over the years 1992 to 1998. The average percentage ownership by foreign interests in the common stock of domestic banks increased from 8.69 percent in 1992 to 14.81 percent in 1998.

...A decline in group ownership brought about by foreign bank entry, and therefore in the relational banking ties these business groups have with certain affiliated domestic banks, creates an environment in which these affiliated banks are significantly affected by competition from the newly entered foreign banks. It appears that group-affiliated banks on the whole are affected more by foreign entry since they had relatively higher pre-liberalization spreads.

The study's results

Effect of foreign bank entry

Evidence from the study indicates that foreign bank entry is associated with a reduction in interest rate spreads and bank profits. However, this finding holds true only for domestic banks that are affiliated to a domestic family business group. We surmise that a decline in group ownership brought about by foreign bank entry, and therefore in the relational banking ties these business groups have with certain affiliated domestic banks, creates an environment in which these affiliated banks are significantly affected by competition from the newly entered foreign banks. It appears that group-affiliated banks on the whole are affected more by foreign entry since they had relatively higher pre-liberalization spreads. We take this to be evidence of a decline in the influence of relationship-based banking.

In addition, as the relative size of the bank increases, the greater the associated decline in interest rate spreads and profits becomes. The study found that the smaller ECBs responded to pending foreign competition by increasing their size more quickly than larger ECBs.

[1]These ECBs comprise approximately 70 percent of the total assets of the Philippine commercial banking sector. They are all publicly traded in the Philippine Stock Exchange (PSE) and rank among the largest 1,000 corporations in the Philippines. Using them allows a direct investigation of the effect of foreign bank entry since the markets served and the services provided by new foreign banks are comparable to those provided by the domestic ECBs. In addition, the analysis captures features of ownership structure that have an important effect in the Philippines, namely group affiliation and ownership concentration.

From these results, we surmise that group-affiliated banks and faster growing ECBs possibly have better political connections and more established relationships, thus, liberalization of foreign bank entry had a more profound effect on their earnings and profits since their political influence might have been lost during this liberalization period.

The study also found that generally, foreign entry corresponds with improvements in operating efficiencies but a deterioration in loan portfolios. Banking liberalization, allowing increased foreign entry, resulted in greater efficiency but it also led to an increase in loan loss provisions. The latter supports the contention of Claessens, Demirgüç-Kunt, and Huizinga (2001) that domestic banks are forced to take on less creditworthy customers due to the increased competition brought by the entry of foreign banks.[2]

Effect of greater foreign ownership in domestic banks

Results of the study show that increases in the percentage ownership by foreign investors in domestic banks are associated with an increase in operating expenses and a decrease in noninterest income. This increase in operating expenses as the percentage of ownership in domestic banks by foreigners increases is in contrast to the general expected effect that the operating expenses decline as foreign bank entry is allowed. This finding may be comparable to that of Barajas, Steiner, and Salazar (1999) which states that there is a component of liberalization unrelated to entry that causes the administrative costs of domestic banks to rise.[3] Perhaps this is related to an increase in intermediation costs resulting from stricter provisioning and reporting requirements that accompanied liberalization. There may also be an increase in costs, specifically those related to activities like the hiring of higher-skilled employees, training of current employees, and the acquisition or upgrading of equipment as banks prepare themselves for competition. This indicates that increases in foreign ownership provide managers the impetus to modernize their operations.

Other findings

The high levels of ownership concentration found in the study's sample ECBs reveal that these banks are closely controlled. However, over our period of study, the average level of concentration has declined. If one compares ownership data for the pre-liberalization year of 1992 to that of the post-liberalization year of 1998, the average insider ownership is shown to decline from 55.34 percent to 43.25 percent, respectively. In addition, it is interesting to note how insiders are split between direct insiders (defined as directors, officers, and related interests [DOSRI]) and group-affiliated companies. In 1992, the total insider ownership portion was composed of 17.77 percent by DOSRI and 37.57 percent by group-affiliated companies. However, by 1998, DOSRI ownership increased to 23.73 percent while group-affiliated ownership declined to 19.52 percent. This suggests a movement by group affiliates away from investments in ECBs and may be a response to the banking and financial market liberalization. Group-affiliated companies were

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[2] *Claessens, S., A. Demirg-Kunt, and H. Huizinga. 2001. How does foreign entry affect the domestic banking market?* Journal of Banking and Finance *25: 891-911.*

[3] *Barajas, A., R. Steiner, and N. Salazar. 1999. Foreign investment in Columbia's financial sector.* IMF Staff Papers 46(2). *International Monetary Fund.*

[4] *Kroszner, R. 1989. On the political economy of banking and financial regulatory reform in emerging markets. Unpublished manuscript.*

probably looking for other alternatives for obtaining funds since their ability to extract wealth through bank ownership declined. Apparently, these groups' capacity to use coercive power over the state to capture rents at the expense of other dispersed interests[4] had waned in the wake of recent changes in political governance and accompanying economic reforms.

General conclusions

Recent reforms in the Philippine banking sector that liberalized restrictions on the involvement of foreign interests appear to have resulted in favorable consequences. However, the narrowing of interest rate spreads is concentrated in banks with higher levels of group-affiliate ownership and the decline in operating expenses is concentrated in fast-growing ECBs. This shows that the intent of the banking liberalization to make domestic banks more competitive and efficient has worked effectively only for those Philippine banks that were able to respond to this competition. In addition, group-affiliated banks, although adversely affected in terms of revenues and profits, are not found to have gained in efficiency since they may be providing benefits to other group corporations, thereby precluding them from markedly reducing operating expenses.

...The intent of the banking liberalization to make domestic banks more competitive and efficient has worked effectively only for those Philippine banks that were able to respond to this competition. In addition, group-affiliated banks, although adversely affected in terms of revenues and profits, are not found to have gained in efficiency since they may be providing benefits to other group corporations, thereby precluding them from markedly reducing operating expenses.

Entry of foreign banks is found to be also directly related to an increase in risk. The increase in loan loss provisions associated with foreign bank entry points to the necessity of having increased monitoring of the financial positions of domestic banks so that they can withstand external economic shocks as they improve their financial positions. Responsibility of monitoring must rest with the Bangko Sentral ng Pilipinas.

The increase in the percentage ownership of foreign investors in domestic banks is shown to result in an increase in operating expenses and a decrease in noninterest income. The former may be explained by the fact that increases in foreign ownership usually involve the granting of incentives to managers to modernize operations, thereby leading to increased intermediation costs. The decline in noninterest income associated with greater foreign ownership, meanwhile, supports a view that with greater levels of foreign monitoring, domestic banks reduce their dependence on nonbanking areas of business.

Overall, the study supports the view of a general weakening of relationship-style banking. Banks that are likely to be more politically connected suffer greater declines in spreads and profits and are able to reduce operating expenses to a greater extent. These banks are thus expected to become more independent and lose much of their political influence. This should lead to better lending practices where the allocation of funds depends more on merit. As a consequence, liberalization of foreign presence will have positive effects on Philippine economic growth and enhance the ability of the domestic economy to overcome negative external shocks.

Policy recommendations

Based on the aforementioned findings, the following recommendations are hereby being made:

- While Republic Act No. 7721 has liberalized foreign bank entry, foreign participation in the domestic banking market, however, is still limited, with the number of foreign banks pegged to 14 and with restrictions on the number of branches these foreign-owned banks may have. In addition, foreign ownership of banks is currently limited in general terms to 60 percent.

As a result of increased foreign competition, current domestic bank corporate governance structure will eventually evolve into one with a higher level of managerial professionalism and more diverse ownership structure. These features are expected to encourage improved underwriting criteria, sounder banking practices, and a reduction in relationship-style banking.

The results of our study suggest that further opening up of the domestic commercial banking market to foreign participation may be beneficial for increased efficiency of domestic banks. Specifically, increased foreign competition should be encouraged by allowing more fully foreign-owned banks to enter the domestic market, increasing the number of branches allowed for each foreign-owned banks, and permitting greater foreign ownership participation in domestic banks.

❇ To mitigate the adjustment costs accompanying greater market openness and the moral hazard problems associated with group-affiliated banks, further liberalization of foreign bank entry and participation should be done in conjunction with built-in safeguards. These can be in the form of credibly enforced government supervision and regulation as well as greater reliance on market mechanisms in monitoring the banking system. Prudential regulations and oversight by a governmental agency are essential means of certifying some sense of economic propriety by corporate groups. They can likewise temper the negative aspects of the relationship-based system of bank governance in the Philippines.

Greater reliance on market mechanisms, meanwhile, is based on a premise that market forces can discipline bank managers by tempering their nonvalue maximizing behavior. This in turn further improves bank performance. Greater reliance on market mechanisms in disciplining banks, however, requires better information and disclosure by banks.

❇ An increased level of transparency and information disclosure also requires the disclosure of bank ownership information. Ownership data, in addition to borrower data, must be provided in an accurate form to regulators and should be made public, especially in cases of larger ownership positions. This information is important since ownership equates to influence over bank activities, especially lending. Lowering the mandatory ownership disclosure from the current requirement of 10 percent to 5 percent share of ownership, as in the United States, and applying this to both private and publicly listed companies may result to a higher degree of accuracy of ownership information. The required information on banks' DOSRI loans and the amount of the DOSRI loans and advances that have become past due should also be detailed enough to disclose the identities of the parties involved.

In the presence of credibly imposed prudential regulations and supervision, and effective monitoring via the market mechanism, group affiliation can be useful in extracting the benefits from a high degree of banking market openness to foreign banks. Eventually, as high levels of transparency and disclosure become an integral part of domestic banking practices, the current banking corporate governance system will be transformed from one that is characterized by relational or social influence to that with more formal controls.

As a result of increased foreign competition, current domestic bank corporate governance structure will eventually evolve into one with a higher level of managerial professionalism and more diverse ownership structure. These features are expected to encourage improved underwriting criteria, sounder banking practices, and a reduction in relationship-style banking. Furthermore, greater independence of commercial banks from family corporate groups system will allow these banks to take on the role of being more effective corporate monitors.

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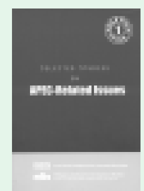

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